New Tax Credits For Renewables Should Offer Investors Relief

By **Kay Hobart** (September 8, 2022)

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Congress recently extended and expanded the tax credits available for renewable energy projects as part of the Inflation Reduction Act. The act fundamentally transforms the tax credit landscape in a number of ways, including allowing the sale of tax credits for cash on the open market.

This is a marked departure from the existing rules, and one that has major ramifications. The new law will undoubtedly affect the financing and structuring of renewable energy projects, which currently often involve complex partnership arrangements.

In addition, it should influence litigation at both the federal and state level regarding the applicability and application of intricate federal partnership rules. This article discusses the law's changes to tax credits, especially the new transferability and refundability provisions, as well as its ramifications for tax enforcement and litigation in North Carolina.

Overview of Inflation Reduction Act Tax Changes

Corporate Tax

The Inflation Reduction Act contains a number of significant tax provisions. For example, the act imposes a new 1% excise tax on designated stock repurchase transactions by publicly traded corporations.

This provision is substantially similar to that contained in the proposed Build Back Better Act, and is designed to discourage stock repurchase transactions, many of which occurred during the pandemic.

In addition, the act imposes a new 15% alternative minimum tax on the adjusted financial statement income of corporations with profits in excess of one billion dollars. This provision is noteworthy because of the interesting intersection between tax and financial accounting rules.

And the Internal Revenue Service has been granted $80 billion to step up enforcement efforts and improve customer service. The IRS has been directed by the secretary of the treasury to submit a plan for the funding, but early speculation is it will include increased corporate tax audits, perhaps in the transfer pricing arena.

Additional guidance is expected with respect to these and other aspects of the new law.

Extension and Expansion of Tax Credits

One important feature of the new law is the certainty of a relatively long-term extension of particular tax credits. Most credits covered in the act have been extended through at least

2032.

For most credits, the act creates a tiered credit system, with the amount of credit increasing if the project meets various criteria. For example, for the investment tax credit, the base credit is 6%. If the project meets prevailing wage and apprenticeship requirements, the credit is increased to 30%.[1]

If the project meets domestic content requirements, there is an additional 10% credit, if the project meets the wage and apprenticeship requirements, or an additional 2% credit, if the project does not meet the wage and apprenticeship requirements.[2]

If the project is placed in what the act defines as an "energy community," the credit is increased by an additional 10%, if the project meets the wage and apprenticeship requirements, or an additional 2%, if the project does not meet the wage and apprenticeship requirements.[3]

Finally, there is an additional 10% credit for small solar and wind facilities — less than five megawatts — located in a low-income community or on American Indian land. If the project is part of a qualified low-income residential building project or qualified low-income economic benefit project, the additional credit is increased to 20%.

Thus, all projects could potentially qualify for a tax credit of 50%. A small project that meets all these requirements and was placed on American Indian land would qualify for a credit of 60%. If that same project were part of a qualified low-income residential building project, it would be eligible for a credit of 70%.

The act also creates new tax credits, including a new credit for energy storage, and a new credit for manufacturing eligible components of renewable energy projects, such as components of wind and solar projects. In addition, solar projects are again eligible for the production tax credit.

Transferable and Refundable Tax Credits

One of the most fundamental shifts is a new provision that allows renewable energy tax credits to be sold on the open market for cash. The new law permits taxpayers to elect to sell all or part of an eligible credit to an unrelated eligible taxpayer for cash.[4]

The purchasing taxpayer may not sell any part of the purchased credit. Eligible credits include the investment tax credit. The cash paid to the selling taxpayer is excluded from the income of the seller, and the buyer is not entitled to a deduction for the purchase price.

For credits held by partnerships or S corporations, the election must be made at the entity level. Transferred credits are subject to the basis reduction and recapture rules, and there are special notification rules in the event of recapture.

If the secretary of the treasury determines that the transfer of an eligible credit constitutes an excessive credit transfer, a penalty of 120% is imposed on the transferee. However, there is a reasonable cause exception.[5] The new law is effective for taxable years beginning after 2022.

The new law also allows tax-exempt entities, state and local governments, the Tennessee Valley Authority, American Indian tribal governments, Alaska native corporations and any cooperative corporation furnishing electricity in a rural area to elect to receive a direct

payment instead of a tax credit for applicable credits, including the investment tax credit.

In addition, this option is available for any entity claiming a credit for the production of clean hydrogen, carbon oxide sequestration or the advanced credit for manufacturing, but it is limited to a period of five years. This election must also be made at the entity level for credits held by partnerships or S corporations.

Again, refundable tax credits are subject to basis reduction and recapture rules, and if the secretary determines that any payment by an applicable entity constitutes an excessive payment, a penalty of 120% is imposed on the entity, subject to the reasonable cause exception.[6]

Interestingly, the transferability provision was not part of the original legislation. Both the proposed Build Back Better Act and the House version of the Inflation Reduction Act would have made all applicable and eligible credits refundable. The bill was amended in the Senate, however, to make many of the credits transferable rather than refundable, including the renewable energy credits.

These provisions reflect a clear congressional policy to permit tax credits to be claimed by taxpayers not otherwise participating in the renewable energy project — thus dramatically expanding the pool of investors, and available capital for investment in favored activities.

History

Explicit transfer provisions will help overcome the limitations on investment at the federal level caused by requiring investors in syndicated projects to run the gamut of subchapter K and its complex and elaborate anti-abuse regulatory and enforcement scheme.[7]

Some history is necessary to properly understand this fundamental shift in federal tax law — and its potentially transformative effect on the financing of renewable energy projects.

Most renewable energy projects are not economically viable without governmental incentives, including tax credits. Tax equity is a critical component of financing most renewable energy projects, because it is an efficient way for the developer to raise capital.[8]

Essentially, the developer transfers the rights to the tax credits and depreciation to entities with a larger tax bill, in exchange for an equity investment in the project. Various tax credit structures evolved over the years, under guidance from the IRS and other taxing authorities.

These structures often involve partnerships in two or more tiers.[9] In return for a direct or indirect investment in the partnership developing the project, the partner is allocated a tax credit.

Tax equity partnership structures have drawn challenges from the IRS under various theories. In Virginia Historic Tax Credit Fund 2001 LP v. Commissioner, for example, the U.S. Court of Appeals for the Fourth Circuit held in 2011 that the transfer of funds to a partnership by its investors in return for state historic rehabilitation tax credits was properly characterized as a "disguised sale" under Section 707 of the Internal Revenue Code.[10]

This being the case, the contribution to the partnership was a taxable event to the partnership rather than a nontaxable contribution of capital. The commissioner of internal

revenue had also challenged the transaction on the basis that the investors were not bona fide partners in the partnership, but the court assumed without deciding that test was met.

A year later, the U.S. Court of Appeals for the Third Circuit took a different approach in Historic Boardwalk Hall LLC v. Commissioner, which involved the federal historic rehabilitation tax credit.[11] There, the commissioner again raised several arguments to disallow the credits, but the court focused on the contention that the taxpayer was not a bona fide partner in the partnership.

The court relied on the test developed by the U.S. Supreme Court in Culbertson v. Commissioner in 1949 to deny the credits.[12] It is important to note that Historic Boardwalk applied the common law version of the economic substance doctrine, and not the test, as later codified in Section 7701 of the Internal Revenue Code.

This is significant because, as the court itself recognized: "Congress was at pains to emphasize that the [historic rehabilitation tax credit] was preserved," as demonstrated in the congressional report.

Virginia Historic and Historic Boardwalk stand in stark contrast to other cases recognizing that otherwise legitimate concerns about abusing the partnership form should not prevent taxpayers from claiming legislatively intended benefits, including the Sacks v. Commissioner decision issued by the U.S. Court of Appeals for the Ninth Circuit in 1995.[13]

The most recent such case was Cross Refined Coal LLC v. Commissioner, in which the IRS suffered a defeat last month at the U.S. Court of Appeals for the District of Columbia Circuit.[14] There, the court held that "partnerships formed to conduct activity made profitable by tax credits engage in legitimate activity for tax purposes," and therefore qualify as partnerships for federal tax purposes.

The court agreed with the Ninth Circuit that after-tax profits should be considered in evaluating whether a partnership is bona fide, "especially ... in the context of tax incentives, which exist precisely to encourage activity that otherwise would not be profitable."[15] Finally, the decision rejected the commissioner's argument that the partners "merely bought tax credits."

Tax Credit Structures and Project Finance

The new transferable and refundable provisions will be a welcome addition to traditional tax equity financing for renewable energy project developers. The extent to which those provisions will replace traditional tax equity financing remains unclear, however, for a number of reasons.

First, although tax credits may be transferred, there is no provision that allows for the transfer of depreciation — another benefit that tax equity investors desire. In addition, it appears that the purchaser of the credit bears the risk of recapture, so this and other risks should factor into the pricing of the credit.

On the flip side, the transferability provision appears to be a direct recognition of the inefficiencies in at least some traditional tax equity financing structures. This provision should also broaden the pool of potential investors and available capital.[16]

As with many of the new provisions in the Inflation Reduction Act, guidance from the Treasury Department and the IRS is needed in a number of respects. But the new law will

no doubt spawn novel structures and vehicles for renewable energy project financing.

Federal Litigation

The new transferability provisions raise significant questions regarding future challenges by the IRS similar to those in Virginia Historic and Cross Refined Coal.[17]

As an initial matter, the new law appears on its face to preclude a disguised sale challenge with respect to a renewable energy credit. Under the new law, a partnership is permitted to sell an investment tax credit, and Congress has specifically stated that the payment for the credit is not taxable income to the partnership.

Thus, it effectively overrules Virginia Historic with respect to any transferable tax credit, because the body of federal tax law surrounding disguised sales is now inapposite to credits transferred by a partnership to its partners.

The new law appears to relegate Historic Boardwalk to the dustbin as well, at least with respect to transferable credits, because it eliminates the need for tax equity investments to come from partners in the project. It seems obvious that the IRS should not be permitted to challenge a credit that has been sold by a partnership to one of its partners on the ground that there is no bona fide partnership or partner.

A more interesting question is whether the IRS would challenge a renewable energy tax credit that was allocated to a partner through a traditional tax equity partnership structure on that basis.

There is an argument that uniformity and respect for the legislative policy to spare tax equity investors from the constraints of partnership anti-abuse doctrines should preclude such a challenge. The countervailing argument, however, is that taxpayers must accept the tax consequences of their chosen structure.[18]

Finally, one must ask whether the IRS will even continue to devote resources to litigating these cases, which are extremely fact dependent, in light of the new law which allows many tax credits to be freely sold.

North Carolina Litigation

The North Carolina Department of Revenue is aggressively challenging state renewable energy tax credits on the same grounds as the IRS.[19]

The department has vacillated among arguments, originally relying on the federal disguised sale and bona fide partner rules, which have not been affirmatively adopted by the North Carolina General Assembly, as required under the state constitution and the Fidelity Bank v. North Carolina Department of Revenue Fidelity Bank case, decided by the North Carolina Supreme Court in 2017.[20]

The cornerstone of the department's current position, however, appears to be that the renewable energy tax credits were sold by the partnership, rather than allocated, which the department contends is illegal. Once again, North Carolina is swimming against the tide with respect to renewable energy credits.[21]

Congress has now spoken, and largely removed the partnership tax limitations on the ability of tax equity investors to secure the full benefit of renewable energy credits. The

department heavily relies on federal law in this area, and this significant federal development could finally end the long-running dispute in North Carolina.

Conclusion

The recent federal changes have important ramifications for the renewable energy industry and tax credit litigation — both at the federal level and in states like North Carolina.

The Inflation Reduction Act reflects a congressional recognition that tax equity investors should be free from the restraints of the complex and onerous federal anti-abuse regime — which should not be applied to disallow legislatively created tax benefits in the first instance.

Correction: Because of an editing error, a previous version of this article incorrectly characterized tax enforcement regimes in North Carolina and other states. This error has been corrected.

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Disclosure: The author currently represents the taxpayer in Integon National Insurance Company v. Department of Revenue, in which the North Carolina Department of Revenue is challenging state renewable energy tax credits.

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[1] The taxpayer and its contractors must pay laborers and mechanics the prevailing wage as determined by the secretary of labor during construction, and for five years after the project is placed in service. Projects that fail to meet this requirement may comply retroactively by paying the proper wages and interest to any underpaid worker, and a fine to the Treasury Department. In addition, the taxpayer and its contractors must use qualified apprentices for specified percentages of the labor hours, which vary depending on when construction begins. A project may come into compliance by paying a fine. There is also a good-faith exception to this requirement.

[2] The taxpayer must certify that steel, iron and manufactured components of the facility are produced in the U.S.

[3] An "energy community" is defined as a brownfield site, an area with historically high employment in the coal, oil or natural gas industry with current high unemployment, or an area with either a closed coal mine or a retired coal-fired electric generating unit.

[4] Entities that may elect to receive a direct payment are not eligible taxpayers.

[5] An "excessive credit transfer" is defined as the amount of the eligible credit claimed by the transferee taxpayer over the amount of the credit which would otherwise be allowable, without regard to the transferability provision or IRC Section 38(c).

[6] An "excessive payment" is defined as the amount treated as a payment by an applicable entity over the amount of the credit which would otherwise be allowable without regard to the refundability provision or IRC Section 38(c).

[7] North Carolina historically did not adopt these onerous and restrictive rules, and the renewable energy industry flourished in the state. In late 2018, however, the department announced that it would begin to apply those rules to state tax credits. See note 18 below.

[8] Often, the developer is not economically positioned to use either the tax credits or depreciation, the other primary incentive. The other components of the capital stack include debt and equity.

[9] One of the most common structures is the partnership flip. Other structures are the sale leaseback and inverted lease.

[10] Virginia Historic Tax Credit Fund 2001 LP v. Commissioner, 639 F.3d 129 (4th Cir. 2011). The partnership had treated the investments as nontaxable capital contributions, and the IRS reclassified the transaction as a taxable disguised sale. When applicable, the disguised sale rule disregards the partner status of the partner, and treats the transaction as occurring between the partnership and someone who is not a partner. For the disguised sale rule to apply, there must be a transfer of money or other property by a partner to a partnership, and a related transfer of money or other property to the partner that, when viewed together, are properly characterized as a sale or exchange. The tax credit in Virginia Historic was specially, i.e., disproportionately, allocable and therefore transferable, according to the court. Importantly, the disguised sale rule does not operate to disallow the tax credits to the investors.

[11] Historic Boardwalk Hall LLC v. Commissioner, 694 F.3d 425 (3rd Cir. 2012).

[12] Culbertson v. Commissioner, 337 U.S. 733 (1949).

[13] Sacks v. Commissioner, 69 F.3d 982, 992 (9th Cir. 1995) ("If the government treats tax-advantaged transactions as shams unless they make economic sense on a pre-tax basis, then it takes away with the executive hand what it gives with the legislative"); see also N.C. Gen. Stat. § 105-130.5A(g) (tax credits must be considered in determining whether a transaction has economic substance and business purpose).

[14] Cross Refined Coal LLC v. Commissioner, 2022 WL 3131167 (D.C. Cir. Aug. 5, 2022).

[15] Id. at *5.

[16] By limiting the refundability provisions to certain entities and certain credits, Congress seemed to choose a middle ground in this regard.

[17] None of those cases involved any of the credits that are transferable under the new law.

[18] Commissioner v. National Alfalfa Dehydrating & Milling Co., 417 U.S. 134 (1974).

[19] There are four separate cases pending in the North Carolina business court. The author represents the taxpayer in one of those cases in which the department appealed an adverse decision from the Office of Administrative Hearings, Integon National Insurance Company v. Department of Revenue, 21 CVS 14395 (N.C. Sup. Ct. filed Oct. 25, 2021).

[20] Fidelity Bank v. North Carolina Department of Revenue, 370 N.C. 10, 803 S.E.2d 142 (2017). In that case, the Department of Revenue properly recognized that the North Carolina Revenue Act is not "a wholesale adoption of all Code provisions and definitions." Instead, as the North Carolina Supreme Court held, federal tax provisions must be affirmatively adopted by the North Carolina General Assembly by clear and specific reference. In the "Important Notice: Tax Credits Involving Partnerships," published on Sept. 10, 2018, the department announced for the first time that it would apply the federal disguised sales and bona fide partner rules to evaluate the state renewable energy tax credit.

[21] See Hobart, Kay (2019), Insight: North Carolina Audits of Tax Credits Cause Broad Concern, Bloomberg Law: Tax.